Submission: Review of KiwiSaver default provider arrangements

Claire Matthews

Section 1: Your details

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The views expressed in this submission are solely those of Dr Matthews, and do not reflect the views of any organisations with which she is involved.

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Are you requesting that any of this submission be kept confidential? ~~Yes/~~No

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Reasons for withholding: N/A

Section 2: Feedback on discussion paper

1. **What is your feedback on the proposed objective for the review?**

I think the objective is a little narrow. A KiwiSaver member is only a default member while they have not made an active choice subsequent to being enrolled in a default scheme. The objectives of the review need to be clearer that the financial well-being of default members may be enhanced by ceasing to be a default member, i.e. by making an active choice about their KiwiSaver account.

2. **What is your feedback on the proposed criteria for the review? How should the criteria be weighted?**

Criterions 1, 3 and 5 are appropriate.

Criterion 2 is reasonable, but it's unclear that the review of default providers is likely to make any real contribution to improving trust and confidence in the sector, and therefore this should have a low weighting.

Criterion 4 is inappropriate for inclusion in this review. Despite the attempt to give it a KiwiSaver focus, the reality is that it is focused on the (necessary and desirable) development of the New Zealand Capital Market, and therefore distracts from the KiwiSaver focus on individuals and their well-being. Inclusion of any capital market-related criterion risks a perception that this is an attempt by the government to transfer KiwiSaver funds into government control, which is highly undesirable and conflicts with Criterion 2.

3. **What is your feedback on the problem definition for the investment mandate? Is a move away from a "parking space" purpose justified?**

The problem definition for the investment mandate is simplistic, and I am unconvinced a move away from a "parking space" purpose is justified. The Discussion Paper suggests default members "are not choosing to move to a fund that better matches their investment needs", but this is making an assumption about the investment needs without anything more than basic demographic knowledge of the default members. Financial advisers are required to undertake a full needs analysis to determine what the appropriate investment choices are for an individual, yet the premise of the Discussion Paper appears to be that growth funds are best for everyone. While growth funds can be expected to achieve better returns in the long term, which should apply for most KiwiSaver members, they also have greater volatility which will not meet the risk appetite of all. This also lacks sufficient consideration of the appropriate investment for a young KiwiSaver member planning to use the funds initially for a first home purchase. It is notable that nearly 40% of KiwiSaver members in a default fund have made an active choice to be there according to the information in the Discussion Paper.

In my view, the "parking space" purpose should be retained for default funds, and more effort put into encouraging default members into making active choices.

4. **Should the investment mandate options (and other options, for example in relation to fees) apply only to default members who have not made an active choice, or should they also apply to members who have made an active choice to stay in the default fund? Why or why not?**

I don't believe it is appropriate to automatically apply any changes to the investment mandate options to members who have made an active choice to stay in the default fund, but it would be appropriate to advise them of the changes and offer an opportunity to change. These members have made an active choice to stay in the default fund as it is currently structured, and cannot be assumed to accept any changes.

5. **If a life-stages option is adopted, what "stages" should apply and to which age groups? Should there be a "nursery" period?**

I don't intend to suggest specific stages if a life-stages option is adopted. I suggest consideration needs to be given to the appropriate type of investment for younger members who may be planning to use their KiwiSaver funds for a first home purchase as a growth fund is unlikely to be appropriate due to the reduced investment timeframe that applies.

If a life-stages approach is adopted, I would strongly support a "nursery" period to allow for engagement with the member and time for an active choice to be made.

6. **If a balanced investment mandate is adopted, what range for growth assets should be applied?**

If a balanced investment mandate is adopted, I suggest a maximum of 50% in growth assets should be applied.

7. **If a growth investment mandate is adopted, what range for growth assets should be applied?**

If a growth investment mandate is adopted, I suggest a maximum of 80% in growth assets should be applied.

8. **If a conservative investment mandate is adopted, what range for growth assets should be applied?**

I think the current range of 15-25% for growth assets in the default fund conservative investment mandate is appropriate.

9. **If a life-stages, growth, or balanced option was adopted, how should we mitigate the potential issue in relation to first-home buyers and other people making early withdrawals?**

Caution needs to be exercised in using information about withdrawals to date to predict the future, as KiwiSaver is still relatively young and past member behaviour reflects characteristics of the start-up phase.

With a life-stages option, the issue of first-home buyers can be mitigated by including first-home withdrawals in the stages.

It is impractical to try to mitigate for people making early withdrawals for reasons other than first-home buyers, due to the difficulties of predicting who this might affect.

The proposal to apply specific member engagement requirements on providers, targeted at potential first home buyers seems a practical approach.

10. **What would be the administrative costs to providers of choosing a life-stages option?**

No comment.

11. **What is your feedback on the different options? Do you agree with our assessment of the costs and benefits of the option? Which option do you think is best and why? Is there another option that we have not considered that would be better than the options discussed?**

While the Discussion Paper suggests the risk of actual losses remains low, the impact of any losses may be out of proportion with the actual losses. It is worth noting that recent research found that the Great Depression of the 1930s was still influencing individuals' financial attitudes and behaviour, as was the finance company collapses of 2008-09 (see Lissington, R.J. & Matthews, C.D. (2012). *Intergenerational transfer of financial literacy*. Paper presented at the Academy of Financial Services Conference, San Antonio, USA., 1-2 October 2012. Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2256791). This suggests that a sharemarket correction that caused a widespread reduction in KiwiSaver balances could have a much greater impact on trust and confidence in KiwiSaver than the actual correction justifies, and this is likely to be amplified in the case of default members.

I remain unconvinced that any move away from the current conservative investment mandate is required.

12. **What is your feedback on the level of value that KiwiSaver default members get for their fees? What are the costs that are within and outside a provider's control? To what extent are fees too high?**

No comment.

13. **Is it a problem that fees disproportionately affect those on low income and under 18s? Why/why not?**

It is not a problem that fees disproportionately affect under-18s. If they are in a default fund, they have made an active choice to be there.

It is a concern that fees disproportionately affect those on low incomes because their ability to save is constrained.

14. **If the government sets a fee, what should the fee be set at for the different investment mandate options? What considerations, methods or models could be used to determine the fee? What should be the balance between fixed and percentage fees?**

While higher fees can be justified for actively managed funds in terms of the work undertaken, research shows that actively managed funds do not necessarily result in better outcomes for the investor. Therefore it can be argued that default funds should have a passive management mandate, which should facilitate lower fees. In addition, the fees set by the government should be tiered, so that as balances grow the proportional fees are reduced.

15. **What fee arrangements would best promote the objectives of the review? What is your feedback on the fee options? Do you agree with the costs and benefits identified? Which option (or the status quo) do you prefer and why? What other approaches or models could be used to reduce fees?**

Option 1 is the simplest approach and ensures consistency between providers. If a provider is dissatisfied with the set fee, they can choose not to be a default provider.

Option 2 seems reasonable, and the variation to take account of the fees in non-default funds is a useful way to extending the value of the review to the bulk of KiwiSaver members.

I strongly support Option 3. The possibility of higher initial fees can be managed by capping those fees.

Option 4 is unnecessary. KiwiSaver is not designed for those under 18, and they have made an active choice to be in KiwiSaver and in the default fund.

Option 5 is worth considering, but there is a (proportionately high) cost of servicing low balance accounts. Is the Government going to cover that cost? If not, that cost is likely to result in higher fees for other members.

I have no particular view on Option 6.

16. **How has the number of providers in the default market affected innovation, competition and value-for-money in the default market and in KiwiSaver more generally?**

No comment

17. **Do you agree with our assessment of the costs and benefits of the different approaches for the number of providers? Can you provide us with evidence that might help us quantify the size of the costs and benefits? What option do you prefer and why?**

With the maturing of the KiwiSaver product, the incumbency effect should be lessened in terms of new enrolments but will continue in terms of the existing default members.

The smaller the number of default providers the greater the perception that they are endorsed by government and are therefore better than the non-default providers.

I suggest the choice should be between a few, selected default providers or an unlimited number. With a standardised default product the cost of monitoring a large number of providers should be reduced.

18. **If a "minimum requirements" approach is taken should this be on a period-based or rolling system, and why?**

A "minimum requirements" approach would be more appropriate on a period-based system to provide greater certainty for members, and to reduce monitoring costs.

19. **Are there higher investment costs for responsible investing? If so, how likely are these costs to contribute to lower net returns?**

No comment.

20. **How does responsible investment affect returns? Does it increase or decrease returns, and to what extent?**

No comment.

21. **Should the default provider arrangements be used to achieve objectives in relation to responsible investment?**

My view aligns closely with the comment in the Discussion Paper that "default members are free to choose a more responsible fund" if they are unhappy with the type of investments being made in their default fund, "and it would be inappropriate for the government to impose a particular set of investment criteria on the default product, particularly if doing so could limit potential returns".

Rather than specifically requiring default funds to have responsible investing guidelines, an alternative may be to require that default providers offer a responsible investment fund that default (and other) members can move to if they are concerned about this issue.

22. **Would default members want their funds to be invested more responsibly? If yes, is the same true if responsible investment means potentially limiting future returns?**

Given the number of default members it is not possible to make a judgement as to whether they would prefer their funds invested more responsibly irrespective of the effect on future returns. It is almost certain that some members would want more responsible investments, but it is also very likely that at least some of those would change their perspective if responsible investment meant potentially limiting future returns. It is not appropriate for default fund settings to be make moral judgements on behalf of individuals.

23. **To what extent is it a problem that default members do not have information about whether their investments are made responsibly? Would having more information make a difference to the behaviour of default members? What alternatives might there be to more/standardised information to address responsible investment concerns?**

Given the apparent apathy of default members, it is unclear that more information about the extent of responsible investing in their fund would make any difference. Nevertheless, additional information in a standard format should be mandated because default members can't act if they lack information. However, is this issue confined to default members? I suggest it would be better for this to be addressed by mandating reporting requirements for all KiwiSaver providers to enhance the provision of information to all members.

24. **Do providers' current responsible investment exclusions meet what default members would expect?**

No comment.

25. **If this option is adopted, what industries or sectors should be excluded? Should the government instead adopt an international exclusion standard or certification regime? What would be the costs associated with an exclusion or certification regime?**

For the purposes of the default funds, adopting an international exclusion standard would provide greater consistency between providers and should be preferred over a certification regime.

26. **If this option is adopted, what form should standard disclosure take? For example, should all providers be required to provide a statement listing all excluded companies by sector?**

If the option of standard disclosure is adopted, requiring default providers to list what is not excluded from a mandated list of 'unethical/irresponsible' investments or sectors is likely to be more effective disclosure as noted in the Discussion Paper. However, this then requires a determination of what the 'unethical/irresponsible' investments or sectors are and may be too narrow to meet the requirements of truly responsible investing. It's important to remember that responsible investing can take a positive approach by choosing to invest in particular companies and sectors, rather than the negative approach of avoiding investment with which it is generally associated.

27. **What is your feedback on our assessment of the costs and benefits of the responsible investment options identified? Which option (or the status quo) do you prefer and why?**

My preference is for standard reporting (Option 2) as Option 1 requires the government to make moral judgements on behalf of individuals. An added benefit of Option 2 is that it could be extended to the entire KiwiSaver market.

28. **What limitations or problems exist in relation to New Zealand's capital markets? How could the settings for KiwiSaver default providers be amended to support the development of New Zealand's capital markets? How do the liquidity and pricing rules affect default provider investment in alternative New Zealand investments?**

No comment – see Q30.

29. **How could the default settings be used to develop New Zealand's capital markets? What parts of New Zealand's capital markets are most in need of development?**

No comment – see Q30.

30. **Should default funds take an active role in helping develop the New Zealand capital markets? Would this support the purpose of the KiwiSaver Act and the accumulation of retirement savings by default members?**

I don't believe it is appropriate for KiwiSaver funds, default or non-default, to be used to address any concerns around the development of New Zealand's capital markets. I have not responded to the other questions in this section given my very strong opposition to the suggestion that default funds should take an active role in helping develop the New Zealand capital markets.

The discussion paper refers to retirement savings in other countries, but it is important to differentiate between pension funds and retirement savings. Pension funds are government funds, like the NZ Superannuation Fund, and if the government decides it is appropriate to use such funds to support the local capital market that is a reasonable decision to make. However, the funds in KiwiSaver accounts are members' personal funds and how those funds are used are for those individuals to make based with a focus on their own retirement needs. Given possible constraints in relation to liquidity and higher risk associated with such investments, it is particularly unsuitable for default members' funds to be directed towards support of the NZ capital markets.

31. **To what extent is the management of default funds currently located in New Zealand or carried out by New Zealand entities?**

No comment – see Q30.

32. **What is your feedback on a New Zealand-based management option? If this option is adopted, which part of the investment process do you think should be based in New Zealand to help develop New Zealand's capital markets? What type of mechanism would best give effect to this requirement?**

No comment – see Q30.

33. **What is your feedback on a targeted investment requirement? If the option is adopted, what market should be targeted by an investment requirement (eg early stage companies)?**

No comment – see Q30.

34. **What is your feedback on our assessment of the costs and benefits of the options to develop New Zealand's capital markets? Which option (or the status quo) is best and why? Is there another option that would be better than the options discussed?**

No comment – see Q30.

35. **What is your feedback on the problem definition for the transfer of members? What other problems are there in relation to the transfer of members?**

I think the problem is well defined in the Discussion Paper.

36. **If default members are transferred from providers with more members to providers with fewer members, how should we decide which members are transferred?**

If this option is chosen, I suggest the only reasonable way to decide which members are transferred would be by random selection.

37. **If transfer option 1 or 2 were adopted, how should default members be given a choice to remain with their current provider for this option?**

Given the apparent apathy of default members, this choice needs to be as simple as possible. A mailed and/or emailed form providing the option from the provider, giving them an opportunity to engage and potentially retain the member, appears the best approach.

38. **What is your feedback on the transfer options and the costs and benefits of the options? Which option (or not transferring at all) do you prefer and why? Is there another better option we have not considered?**

I prefer Option 1. If Option 2 is selected, there is an incentive for the five largest default providers to not engage in the tender process. The share of default members appears closely linked to whether the default provider was appointed in the first or second appointment round, and also reflects the reduced number of default members now joining KiwiSaver. This also has the potential to substantially disadvantage a large number of current default members who would lose the protections of being in a default fund.

39. **What factors should the review consider in deciding transition timeframes?**

The Discussion Paper appears to have identified the key considerations for deciding transition timeframes. A staggered transfer is likely to be more suitable to avoid market disruption, and to be manageable.

40. **Should active defaults be considered default members for the purposes of transfers? How should active defaults be treated and notified of any changes to default provider settings?**

I don't believe active defaults should be considered for the purposes of transfers. However, as the Discussion Paper notes these members may expect to continue receiving the benefits that come from default provider settings, and it is therefore important that they be made aware of the change. Like default members, there should be a requirement for the provider to communicate with the active default member to advise of the change, but the passive/default choice would be to remain with the provider in a non-default fund and the member would actively have to request a transfer.

41. **What is your feedback on the member education requirements that default providers should have in relation to default members, and how these should be enforced in the instruments of appointment?**

I support for default providers to be obliged to provide a level of financial education to their default members, rather than the current simpler requirement to report on the education provided. The FMA guidance is the bare minimum that should be required, and providers should be encouraged to go beyond that minimum. Obligations should be in the form of a required number of contacts and quantum of information provided.

42. **What is your feedback on the other requirements that should apply to default members?**

No comment.

43. **Any other feedback?**

No comment.